BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JAMES R. AND JANE M. BANCROFT)

For Appellants: E. Samuel Wheeler
Certified Public Accountant

For Respondent: Bruce W. Walker
Chief Counsel

Brian W. Toman
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of James R. and Jane M. Bancroft against a proposed assessment of additional personal income tax in the amount of $1,860.78 for the year 1971.

This appeal raises several questions concerning the proper method of computing the tax on appellants' 1971 tax preference income pursuant to section 17062 of the Revenue and Taxation Code. [1/]

Section 17062, in effect December 8, 1971, provides in pertinent part:

> In addition to the other taxes imposed by this part, there is hereby imposed ... a tax equal to 2.5 percent of the amount (if any) by which the sum of the items of tax preference in excess of thirty thousand dollars ($30,000) is greater than the amount of net business loss for the taxable year. (Emphasis added.) [2/]

The term "net business loss" is defined in section 17064.6 as 'adjusted gross income (as defined in Section 17072) less the deductions allowed by section 17252 (relating to expenses for production of income), **only if** such net amount is a loss." As originally enacted in 1972, section 17064.6 did **not** contain the words "only if such net amount is a loss." (Stats. 1972, ch. 1065, § 1.6, p. 1980.) Those words were added by amendment in 1973. (Stats. 1973, ch. 655, § 1, p. 1204.)

Appellants computed the section 17062 tax on their 1971 tax preference income as follows:

Items of tax preference:		
Accelerated depreciation	$ 23,342	
Excess depletion	2,884	
Nontaxable capital gains	78,205	
Total tax preference income		$104,431
Less:		
Statutory exclusion	$30,000	
"Net business loss"	**81,940**	
		111,940
Taxable tax preference income		**$ --o--**

1/ Hereinafter, all references are to the Revenue and Taxation Code unless otherwise indicated.

2/ Section 17062 was amended in 1975 to include a new tax rate schedule and to reduce the $30,000 exclusion to $4,000. (Stats. 1975, ch. 1033, § 1, p. 2434.) However, the changes have no bearing on the outcome of this appeal.

The $81,940 "net business loss" claimed by appellants was not computed pursuant to the definition of that term set forth in section 17064.6. Consequently, after conducting an audit of appellants' 1971 return, respondent disallowed the $81,940 "net business loss" and recomputed the tax on appellants' tax preference income. Initially, respondent determined that appellants had incurred no "net business loss" in 1971 because their adjusted gross income less the deductions allowed by section 17252 (relating to expenses for production of income) did not amount to a net loss. However, subsequent to the filing of this appeal, respondent reviewed its computation of appellants' "net business loss' under section 17064.6. Apparently, respondent now concedes that its proposed assessment should be adjusted to reflect the allowance of a 'net business loss" in the amount of $1,782. 3/

Appellants' primary contention on appeal is that the definition of "net business loss" set forth in section 17064.6 is not applicable for purposes of computing the preference income tax for taxable years prior to 1972. The issue and arguments raised by appellants in this connection are substantially similar to those considered by this board in the Appeal of Richard C. and Emily' A. Biagi, decided May 4, 1976. On the basis of our decision in Biagi, and for the reasons stated therein, we must conclude that respondent's action in computing appellants' "net business loss" pursuant to section 17064.6 was proper. (See Appeal of Robert S. and Barbara J. McAlister, Cal. St. Bd. of Equal., April 6, 1977.)

The second issue raised by this appeal concerns the manner in which respondent computed appellants' "net business loss" under section 17064.6. As we indicated above, section 17064.6 defines "net business loss" as "adjusted gross income (as defined in Section 17072) less the deductions allowed by Section 17252 (relating to expenses for production of income), only if such net amount is a loss." Appellants contend that respondent

3/ The record indicates that in recomputing appellants' "net business loss" respondent erroneously omitted "one interest item of $7.00." Thus, we have added the $7.00 item to the "net business loss" which respondent has conceded is correct.

erred in its interpretation and application of that portion of the formula set forth in section 17064.6 which refers to "the deductions allowed by Section 17252 (relating to expenses for production of income)."

After finding error in its initial computation of appellants' "net business loss", respondent recomputed the loss as follows:

Adjusted gross income		$6,383
Less § 17252 deductions:		
Interest expense	$7,948	
Taxes	203	
Safe deposit box	14	
		8,165
"Net business loss"		($1,782)

During 1971, appellant incurred expenses for state disability insurance and tax return preparation services. Appellants contend that respondent erroneously omitted these two items from its computation of "the deductions allowed by section 17252 (relating to expenses for production of income)." Respondent, on the other hand, contends that neither of these items fall within the phrase in question. With respect to the expense for state disability insurance, it is respondent's position that such expense is not deductible under section 17252. With respect to the expense for tax return preparation fees, respondent apparently concedes that the expense is deductible under section 17252. (Cal. Admin. Code, tit. 18, reg. 17252, subd. (1).) However, it is respondent's position that such expense does not fall within the phrase "the deductions allowed by Section 17252 (relating to expenses for production of income)" because the expense is not related to the production of income. Thus, it is respondent's opinion that the parenthetical phrase "(relating to expenses for production of income)" limits the section 17252 deductions which may be considered in computing a taxpayer's "net business loss" to those which are directly related to the production of income.

Section 17252 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year--
>
> (a) For the production or collection of income;

(b) For the management, conservation, or maintenance of property held for the production of income: or

(c) In connection with the determination, collection, or refund of any tax.

We must agree with respondent's conclusion that the expense incurred by appellants for state disability insurance is not deductible under section 17252. While it might be true, as appellants apparently argue, that the expense is indirectly related to the production of income, the income ultimately generated by the expense will not be includible in the recipient's gross income. (Rev. & Tax. Code, § 17138.) Items of expense which are related to the production of tax-exempt income are not deductible under section 17252. (See Rev. & Tax. Code, § 17285: Cal. Admin. Code, tit. 18, reg. 17285(a); Cal. Admin. Code, tit. 18, reg. 17252, subd. (d).)

The question whether tax return preparation expenses fall within the phrase "the deductions allowed by Section 17252 (relating to expenses for production of income)' presents a more difficult problem. Subdivision (c) of section 17252 allows the deduction of such expenses regardless of whether the expenses are incurred for or relate to the production of income. 4/ If, as appellants apparently argue, the deductions allowed by subdivision (c) fall within the phrase in question, then the parenthetical phrase "(relating to expenses for production of income)" must be construed as mere surplus language intended to describe the general subject matter of the statute to which it refers. We cannot accept this construction of the phrase in question.

The fundamental objective of statutory construction is to ascertain and give effect to the legislative

4/ The record contains no evidence that any portion of the tax return preparation fees incurred by appellants is allocable to either their trade or business or their income-producing activities. Therefore, our resolution of this issue is based upon the conclusion that the fees were of a personal nature and, therefore, deductible only under subdivision (c) of section 17252. (Cf. Bonnyman v. United States, 156 F. Supp. 625 (N.D. Tenn. 1957), affd 261 F.2d 835 (6th Cir. 1958); Clarence Wood, 37 T.C. 70" (1961).)

intent and purpose behind a statute. (Helvering v. Hammel, 311 U.S. 504, 511 [85 L. Ed. 303] (1941); Stafford v. Realty Bond Service Corp., 39 Cal. 2d 797, 805 [249 P.2d 241] (1952).) Moreover, it is an elementary rule of statutory construction that effect must be given, if possible, to every word, clause, and sentence of a statute so that no part will be inoperative or superfluous. (Select Base Materials, Inc. v. Board of Equalization, 51 Cal. 2d 640, 645 [335 P.2d 672] (1959).)

The definition of "net business loss" set forth in section 17064.6 was designed to identify the portion of a taxpayer's items of tax preference which do not produce an actual tax benefit. (Appeal of Richard C. and Emily A. Biagi, supra.) It is significant that the Legislature achieved this result by defining "net business loss" in terms of adjusted gross income as reduced by the deductions allowed by section 17252 (relating to expenses for production of income). As we indicate in the Appeal of Paul and Melba Abrams, decided this date, the legislative purpose for defining "net business loss" in this manner is to place taxpayers engaged in activities for production of income on an equal footing, for purposes of the tax on preference income, with taxpayers engaged in a trade or business. This purpose will not be furthered by construing the phrase in question to include the personal deductions allowed by subdivision (c) of section 17252. Furthermore, as will be explained in greater detail later in this opinion, we believe the Legislature intended to exclude such personal deductions from consideration in computing a taxpayer's "net business loss" under section 17064.6. For these reasons, and to avoid a construction of the parenthetical phrase "(relating to expenses for production of income)" which would render that phrase superfluous, we must conclude that the expense incurred by appellants for the preparation of their personal tax return was properly omitted by respondent in computing appellants' "net business loss" pursuant to section 17064.6.

The final issue presented by this appeal concerns the propriety of imposing the tax on preference income without allowing an offset against such income equal to the amount by which the taxpayer's taxable income is less than zero. Specifically, appellants assert that a portion of their items of tax preference equal to their negative taxable income 5/ did not produce an actual tax benefit and, consequently, should not be subject to the tax imposed by section 17062.

5/ Appellants reported negative taxable income of $6,623 On their 19'71 return.

While we agree with appellants' assertion that the tax on preference income should not be imposed where such income has failed to produce an actual tax benefit, we do not agree with appellants' contention that reference to a taxpayer's negative taxable income must be made in order to identify the portion of tax preference income which has not produced a tax benefit. As we indicated in Biagi, supra, the Legislature clearly intended that the tax on preference income be imposed only to the extent that such income produces a tax benefit. However, we believe the Legislature achieved precisely this result by including in section 17062 an offset against tax preference income equal to the "net business loss". (See Appeal of Robert S. and Barbara J. McAlister, supra.) This relationship between the "net business loss" and tax preference income may be illustrated by reference to the particular facts of the instant appeal.

The record on appeal indicates that appellants received gross income of $332,367 in 1971. Yet, appellants' adjusted gross income, as reduced pursuant to section 17064.6, was a negative $1,782. [6/] The $334,149 difference between appellants' gross income and revised adjusted gross income represents the sum of three separate categories of deductions or tax-exempt income: (1) the deductions, other than those which constitute items of tax preference, allowed by section 17202 in computing adjusted gross income--$221,553; (2) "the deductions allowed by Section 17252 (relating to expenses for production of income)"--$8,165; and (3) the items of tax preference--$104,431. Pursuant to sections 17062 and 17064.6, the first two categories reduced appellants' gross income by $229,718, while the items in the last category reduced appellants' gross income by an additional $104,431, resulting in a negative revised adjusted gross income of $1,782. However, since there is no tax advantage, under California law, associated with a negative adjusted gross income, the portion of appellants' items of tax preference equal to their revised adjusted gross income produced no tax benefit. Therefore, appellants are entitled to offset that amount, which is their "net business loss", against their items of tax preference in computing the tax imposed by section 17062.

6/ For convenience, adjusted gross income as reduced pursuant to section 17064.6 shall hereinafter be referred to as revised adjusted gross income.

With this relationship between the "net business loss" and tax preference income in mind, the reason for the Legislature's decision to define "net business loss" in terms of adjusted gross income rather than taxable income becomes apparent. Prior to 1977, the items of tax preference were, without exception, a product of business or income producing activities. (See Rev. & Tax. Code, § 17063.) 7/ The deductions allowed in computing adjusted gross income and the deductions allowed by section 17252 which relate to the production of income are, for the most part, directly related to business or income producing activities. However, the deductions and exemptions allowed in computing "taxable income" include items of a personal nature which have no direct connection with business or income producing activities. (Compare Rev. & Tax. Code, §§ 17072 and 17201-17240 with Rev. & Tax. Code, §§ 17253-17265.) We believe that by defining "net business loss" in terms of adjusted gross income rather than taxable income the Legislature intended to eliminate from consideration, in ascertaining the extent to which items of tax preference produce a tax benefit, personal deductions and exemptions which have no relationship to the production of tax preference income. Therefore, we must conclude that appellants are not entitled to an offset against tax preference income equal to their negative taxable income in computing the tax imposed by section 17062.

7/ In a recent amendment to section 17063 the Legislature added to the list of items of tax preference an item equal to the "excess itemized deductions." (Stats. 1977, ch. 1079, § 17.) Although this new item of tax preference is not a product of business or income producing activities, it is our opinion that the recent amendment has no bearing on the outcome of this appeal since the amendment is effective only with respect to taxable years beginning after December 31, 1976.

Appeal of James R. and Jane M. Bancroft

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of James R. and Jane M. Bancroft against a proposed assessment of additional personal income tax in the amount of $1,860.78 for the year 1971, be and the same is hereby modified 1.0 reflect the allowance of a "net business loss" in the amount of $1,782 in computing the tax on appellants' 1971 tax preference income. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 11th day of January, 1978, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member